DR. KURT RICHEBÄCHER

Frankfurt
GERMANY

CURRENCIES AND CREDIT MARKETS

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"Should the Fed raise the rediscount rate, and deliberately invite a violent reaction? Or should it wait for the raging speculative fever on Wall Street to play itself out and risk an almost certain depression in the longer run — for prosperity could not continue indefinitely if such an extensive proportion of the nation's credit was imprudently diverted from the actual production and exchange of goods and services into financial speculation."

1929 The Year of the Great Crash, W.K. Klingman
Harper and Row, New York 1989, p. 114

HIGHLIGHTS

This letter disentangles the U.S. monetary muddle. It shows the causal linkage between the Fed's oversupply of reserves, soaring M1 and raging financial speculation on the one hand, and contracting broad money supply and sluggish economic activity on the other.

Another wrong-headed dollar rally appears to be under way. A huge crowd of currency traders, clutching their chart books, have again been mobilized into an unthinking frenzy. Simple logic and fundamentals rule out a dollar bull market.

The outbreak of euphoria over stronger U.S. employment is misplaced. It signifies that the widely trumpeted productivity-led recovery is disappearing into thin air. Now that the economy is employment-led, it means higher labour costs and lower profits.

The biggest risks for the U.S. economy are in the stock and bond markets. Although the Fed talks tough, its action betrays continuing aggressive ease. But instead of stimulating the economy, it stokes a financial mania.

Surging M1 is a sign of an inflation that has nothing to do with the real economy. It's a most disastrous kind: financial inflation. Big financial bubbles, sooner or later, must end in a bust. The experiences of 1929, 1937 and 1987 are undeniable evidence.

The D-mark and the Bundesbank are currently under attack. The Bundesbank, though, shouldn't be underestimated. Recent events have considerably strengthened the hawks in the Bundesbank.

There is risk that an emerging interest rate war between France and Germany could lead to some trouble for the French franc and its bond market. French politicians are in a panic about the possibility of a deepening recession raising unemployment higher than it already is.

Long-term capital conservation and liquidity continue to be the top priorities. We continue to recommend safe harbour in the short-term money securities and bonds of the strong-policy currency countries — Germany, the Netherlands, Switzerland as well as Austria and Belgium.

LEMMINGS AND PIED PIPERS

The world economy continues to weaken and recovery expectations continue to come up short. Yet, financial markets, although somewhat jittery and confused, still take strange comfort from unfavourable news. To their interpretation, the more economic disappointments there are, the easier money will become and the surer will be the prospect of an eventual recovery. Little note is taken of the fact that this circularity in thinking has already stretched out for one or more years in the case of some countries — notably the U.S., Britain, Canada, Australia, and Japan — with little convincing result. Similarly ridiculous has been the dollar's recent jump against the major currencies — particularly the D-mark. This move blatantly flies in the face of a sharply slowing U.S. economy and a widening trade deficit. How can one make sense of all this? We can only say that the fundamentals will eventually reveal their ugly truth. It's only a matter of time.

Before turning to the fundamentals, why the sudden spurt in the dollar? When outlining the many fundamental reasons for our long-term dollar bearishness in past letters, we have always pointed out that the majority of the world's currency traders and economists have always been loaded for "bull" when it comes to the dollar. For years — at least since the mid-1980s — the consensus has been incessantly bullish on the dollar, expecting it to rise and never to fall. There has always been a gaggle of traders ready to interpret the slightest dollar blip as the beginning of a new long-term trend. And since the vast majority of currency traders and institutional investors are guided by little more than price and momentum charts, like lemmings, they tend to move en masse. All they need is a pied piper to rally them. This time it's the reputed Midas touch of Mr. George Soros, the man famous for pushing the pound sterling out of the ERM (European Rate Mechanism) and launching the recent gold rally, that triggered the rallying cry for the dollar.

Adding to this volatile brew is the fact that the world's currency trading resources have literally exploded during the last decade. Currency trading volumes have more than tripled during the last six years, egged on by the fast-growing cross-border transactions of investors and portfolio managers. Given such a large herd of foot-loose money, virtually anything can happen over the short run.

The point of all this is to say that some dollar strength is always plausible for a short time. The truly important question, though, is whether or not the assumptions and fundamentals underlying the move are in alignment for the long-run. Only then can a long period of dollar strength be anticipated.

Reviewing the case for the dollar, we conclude that we're seeing another of the many dead-end rallies. It's based on little more than hype, psychology and speculation with the media playing a glad midwife. Reports about the German economy and the Bundesbank are absurdly distorted on the negative side, while those on the U.S. economy and the Fed are even more stretched on the positive side. Any trivial negative news about the German and other European economies makes headlines. Even worse, there seems to be a virtual campaign to tarnish the Bundesbank's credibility, particularly from British and French economists, conjuring up the probability of a future devaluation of the D-mark.

THE DOLLAR: CHECKING THE FUNDAMENTALS

It's best to concentrate on the fundamentals. We have had long experience at it, being able to see through the smoke and mirrors of numerous false currency moves in past years. Just what are the chief arguments of the dollar bulls? There is the one monotonous drumbeat: that a strengthening U.S. recovery will cause rising interest rates and pull in foreign capital, thereby driving up the dollar. This argument

is faulty on more that one count. First, instead of seeing a strengthening economy, there is a fragile — in fact weakening — recovery with record-low interest rates. Second, it's a mystery how conditions of sluggish credit growth and low interest rates are supposed to attract foreign capital. U.S. stocks and bonds are already among the most overvalued in the world. That simple logic alone explains why the recent dollar bull speculation will again go sour. The dollar's upturn is driven by speculation, not by long-term capital inflows.

In our opinion, the final test that will settle the bull or bear case for the dollar is now imminent. Recent economic and monetary data overwhelmingly and compellingly indicate that the U.S. economy is slipping back into recession . . . even before the new depressants of tax increases and spending cuts begin to bite. Activity is soft across a broad spectrum of the economy. Yet, so far, bad news is either ignored or treated as good news. A case in point is the sharp rise in the May U.S. trade deficit. It occurred in the face of extremely weak domestic demand, signifying very negative news both for GDP (gross domestic product) growth and U.S. competitiveness. Instead, the rise in the trade deficit is being broadly interpreted as a sign of economic strength.

Perverse psychology is at play here. Weakness is literally perceived as strength in the stubborn belief that a continuing U.S. recovery is solely predicated on low inflation and low interest rates. Rather than seeing a feeble recovery as being inherently vulnerable, the logic is turned on its head with the paradoxical argument that the recovery must be durable precisely because it is slow. Such is the sophistry of today's economists in the absence of theory . . . the study of causes and effects. It reminds us of 1989-90 when it was happily argued that falling interest rates precluded any possibility of a recession — the so-called "soft landing." Since it had never happened before in the post-war period it was thought to be impossible. Yet, the recession did occur.

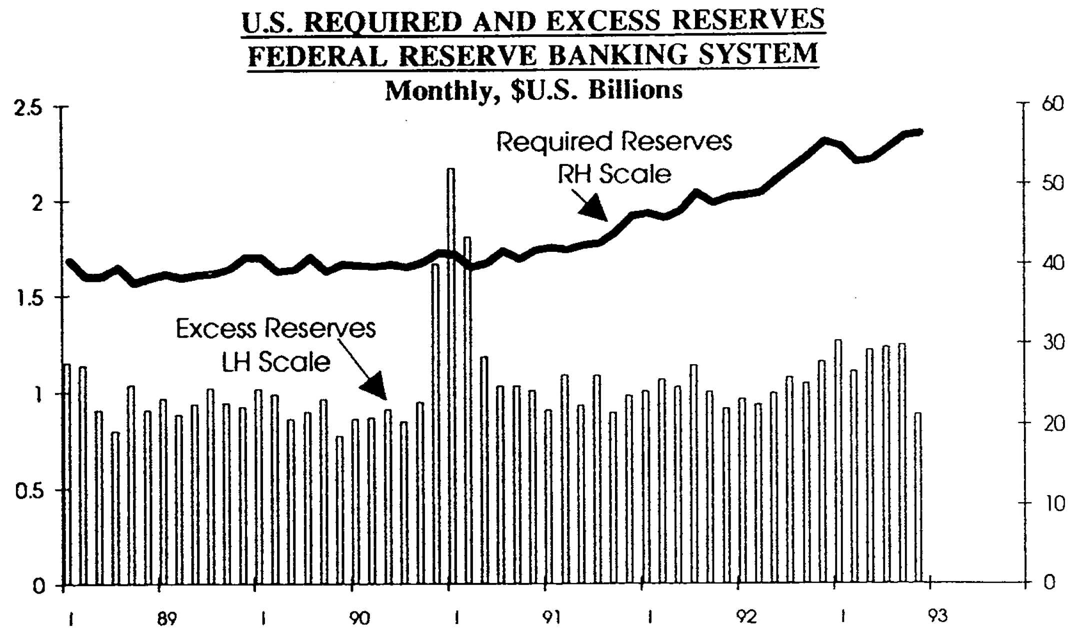
FED POLICY: TOUGH TALK, SOFT STICK

Despite compelling evidence to the contrary, a U.S. economic rebound in the second half of the year — to a 3% growth rate and more — is simply taken for granted. A by-product of this view is persistent talk of an impending Fed tightening. This expectation is revealed in the Eurodollar futures market which is discounting a rise in the Federal funds rate to 4% by year-end, up a full 1% from today.

Abetting these expectations is the Fed's "open-mouth" anti-inflation policy: couching soft action with strong words. The story that the Federal Open Market Committee has put a tightening bias on its policy stance, smacks of a deliberate leak in order to give the impression of anti-inflation vigilance and to mould market expectations in favour of lower long-term interest rates.

Given the massive speculative bubble in U.S. bonds, the markets are understandably eager to take all of this very seriously. And besides, this kind of talk tends to prop up the dollar. To us, it's a transparent "confidence" ploy.

Talking strongly but acting softly is the Fed's real policy. The evidence clearly shows that to be so. To begin with, if the Fed were truly vigilant against inflation, it would meanwhile have tempered its prodigious reserve injections that have been flooding the banking system. The manifest fact is this: In trying to keep the Fed fund interest rate at its low level of 3%, it has been buying Treasury bonds — monetizing government debt — at warp speed. With the resulting excess reserves that this action creates, the Fed, in turn, has been pressuring the banks to expand their own bond portfolios. Last year, bank



Source: Federal Reserve

reserves temporarily skyrocketed upwards at an annual rate of 25% and higher.

The rapid rise in bank reserves — deposits to be held by the banks with the Fed — has four interconnected reasons: first, the record-high bank purchases of bonds create a corresponding amount of new deposits; second, the stampede of the public into securities precipitates a large-scale switch from savings and time deposits into demand deposits (M1) which are needed for the related payments; third, this boost to demand deposits, solely subject to the Fed's reserve requirements, has been increasing the bank's reserve demand; and fourth, the Fed fosters this process, as the chart above shows, with a permanent oversupply of reserves.

Normally such surging reserve demand would put upward pressure on short-term interest rates. But the Fed's generous reserve supply clearly testifies to its eagerness to keep short-term interest rates low. This combination of a 3% funds rate and excess reserves has still another effect which the Fed and the markets really like: as long as there are excess reserves, it pushes the banks to make massive bond purchases which act to lower the long-term interest rate. During the three months to April of this year, U.S. banks bought bonds at a record annual rate of $150 billion. In short, the buoyancy of the U.S. bond market is the product of the Fed's lavish reserve injections. It couldn't be clearer: Despite its protestations, the Fed continues to be a softy. Why? Because, as we'll explain, it can't very well do anything else. The Fed has become a hostage of its past largesse.

GREAT INTENTIONS, SMALL EFFECT

Looking at the actions of the Fed or any other central bank, we always distinguish between the intent of monetary actions and their effects. In principle, we fully agree with those who accuse the Fed of pursuing a policy of reckless monetary expansion. That's clearly evident in the explosive rise of bank reserves, the monetary base and narrow money (M1).

But, as over-expansive as the monetary policy is, the crucial point is this: It's miserably failing to achieve its aim of stimulating the economy. To do so would require re-starting the credit engine . . . more precisely, boosting bank lending to businesses and consumers. In this way, the Fed's monetary ease would be passed through to the private sector. That's the normal way how money growth takes place. But this time, the channel to the real economy fails to function.

That brings us to the recent inflation scare. The many American economists who see rapid inflation of consumer prices just "*around the corner*" fail to draw a distinction between the intent and effect of monetary policy. Apparently, that's a fear shared by many American monetarists who tend to regard three monetary indicators — bank reserves, the monetary base (also called high-powered money) and narrow money (M1) — as the best indicators of the current monetary thrust and inflation outlook.

How do these monetarists explain the connection between these three aggregates and economic activity or inflation? They don't. They simply rely on the evidence of econometrics and historical correlations. That's why they have a slavish and narrow focus on these indicators and totally neglect credit and broad money trends.

By these gauges, present U.S. monetary policy evidently appears extremely inflationary. That's absolutely correct. But the crucial point to see is that these prodigious reserve injections and the associated M1 surge, while inflating the financial markets, completely fail to impact the real economy. As far as economic activity is concerned, the Fed is obviously "pushing on a string" just as in the 1930s when this expression was first coined. The main channel, through which monetary policy impacts the real economy, is credit and broad money growth. And both remain stalled. What this signals is a progressive shrinkage of overall liquidity.

Although our view is almost a "lone voice in the wilderness" it's by no means a maverick view . . . a figment of our imagination, so to speak. It is rooted in the tradition of European credit theory. The fathers of this school of thought — both British and Continental European — were Europe's leading economists over a period of more than two centuries.

A GROUNDING IN THEORY

This original European approach, stressing the role of credit and broad money, is guided by four important insights: (1) No one borrows money to hold it in an idle bank account. Borrowed money is normally spent. (2) The growth of money — mostly consisting of bank deposits — is driven by growth of bank credit, both loans and investments. Every increase in bank assets mechanically translates into an equal increase in liabilities and therefore in the supply of broad money. (3) Only a credit expansion makes it possible for spending to increase beyond current income growth, leading to a rise in production which, in turn, leads to a subsequent increase in incomes. (4) Credit analysis, as well, allows valuable insights into the purposes for which borrowed (created) money is used. It makes a fundamental difference, for example, whether a monetary expansion finances business investment which has high multiplier effects on the rest of the economy or increased government spending which has low multiplier effects. Today, virtually all of the credit growth is in the latter category.

Yet, the relationship between credit or money growth and GDP growth can vary considerably because a large and varying share of spending does not affect output. There are, principally, three different outlets for money spending: (1) domestic goods and services — the current output of the economy; (2)

existing financial and real assets that are not a current product of GDP; and (3), foreign goods, services and assets. Of these three types of spending, only the first impacts domestic production. If only the latter two types of transactional spending are stimulated, there will be little relationship between GDP growth and money and credit.

THE U.S. MONETARY SCHIZOPHRENIA

A review of recent U.S. monetary growth rates illustrates this point vividly. Take a look at the money trends shown in the neighbouring table and the graph on page 8. There is an eye-catching discrepancy between soaring narrow money growth and flat broad money growth. This gap was even more pronounced for a time last year. It has shrunk considerably since then, since M1 suddenly slowed as of late last year, too. The second most remarkable feature in the monetary picture is the fact that whatever broad money growth there was since last year, has come from its soaring M1-component. The other components of M2 and M3 — their so-called non-transaction parts — have virtually collapsed. As such, this development is unprecedented.

RECENT U.S. MONETARY TRENDS
Annualized Percent Changes

	M1	M2	M3	Non-Financial Debt
1992 Year	14.2	1.5	-1.3	5.1
Six Month Changes to:				
January	14.5	1.4	-1.3	4.5
February	11.8	0.2	-2.1	4.4
March	9.2	-0.4	-2.6	4.8
April	7.4	-1.0	-2.1	5.0
May	9.4	0.4	-0.4	

Source: Economic Indicators, Department of Commerce

All these numbers and technicalities may appear complicated and tedious. But they are unavoidable. Their investigation is crucial to understanding the future. What we read from most economists — even from the Federal Reserve itself — gives us the frightening impression that they lack such insight.

In the minutes of the Federal Reserve Board Open Market Committee Meeting of February 3, 1993, the Fed expressly attributes the protracted weakness of the broad money to the steep yield curve which is causing investors to switch from deposits into securities. Deposits are counted as part of the money supply, whereas securities are not. This explanation, in line with the market view, has the great attraction of dispelling any concerns, and instead, even puts the money weakness into a rosy light.

Do securities purchases — stocks, bonds and/or mutual funds — by the public reduce the money supply? Does the purchase of an automobile reduce the money supply? Of course not. Such a misjudgment by a central bank is frightening. What really happens in connection with such purchases is that M1 is boosted at the expense of the other components of broad money because it requires an increase in transaction money. But since M1 is a component of broad money, broad money must remain unchanged.

Even more shocking is the Fed's reference to the unprecedented steepness of the yield curve, citing it as a main depressant of broad money growth. Precisely the opposite is true. The steep yield curve is the very incentive for the banking system's massive purchases of government bonds. Having bought roughly $90 billion worth over the last 12 months, it is in reality the one outstanding source of current

U.S. money creation. Our May letter described the significance of this process as well as monetization and other related topics.

Although bank purchases of bonds have been strong over the past year, there was a sharp slowdown during the November-February period which was promptly reflected in temporarily weaker money growth. Since then, there has been a renewed thrust of bond purchases to record levels as already mentioned. This has provided a new boost to money growth. How the Fed can blame low money growth on the steep yield curve is beyond us. It would be more correct to say that the massive monetization of government debt has prevented a liquidity collapse in the private sector.

TWO CIRCULATIONS: M1 AND THE SPECULATORS, BROAD MONEY AND PRODUCTION

Why is it that this hugely aggressive monetary policy is so ineffective in stimulating the real economy? As already explained, the main cause is that the banking system is failing to pass the stimulus through to the economy by more lending to the private sector. Is most of the Fed-induced stimulus just disappearing down a black hole without any effect? No, it's just that the impetus is careening down a different channel: namely, into the financial markets. This has important and dangerous implications.

Two unusual developments set the stage for this discussion as we've already briefly explained. Compared with past recoveries, the great anomaly in the U.S. monetary situation is the fact that bank lending to the private sector is non-existent. That does not mean that the banking system is inactive. Though it may not be monetizing private debt, it is busily monetizing government debt at an unprecedented scale.

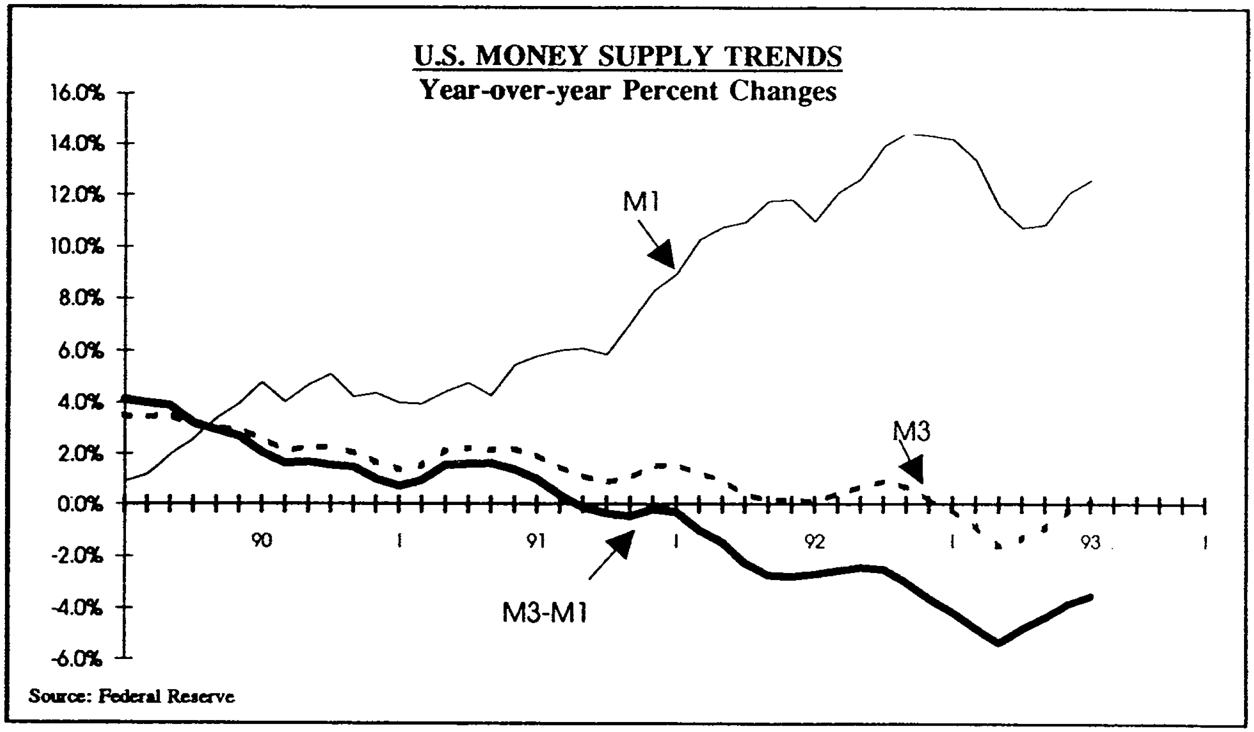
The second anomaly is a dramatic shift in the composition of money growth in favour of soaring M1. While M1 jumped over the last 12 months by 13%, broad money has virtually stagnated. Were it not for the surging M1 component, broad money and overall liquidity would have sharply contracted. The graph on the next page illustrates this point.

Most observers dismiss this divergent behaviour of narrow and broad money as being a result of superficial velocity changes. For us, this extreme decoupling in the behaviour of the different M's has an obvious, ominous implication: inflation.

Yes, surging M1 signals inflation, but not in the way most economists think. Plainly caused by artificially low short-term interest rates, it fuels rampant inflation in the financial markets. As explained, sharply rising turnover in the financial markets, both cash and derivatives, requires rising cash balances which boosts the growth of demand deposits and related reserve requirements. But, this money circulates outside the gross national product. That's why it doesn't generate inflation in goods and service prices.

What, then, about the unusual weakness of broad money? Just as clearly, it reflects very opposite conditions in the real economy: credit deadlock and illiquidity. It's plain to see that there are two circulations at work.

This brings us again to the role of the Fed. What's driving U.S. financial markets and forcing up stock and bond prices? Clearly, the ability of the banks to buoy the bond market with their huge purchases. It's the Fed that stokes the speculative furnaces with an oversupply of reserves. Some brokers expressly cite the rapid reserve growth as being bullish for the markets, not realizing that this is the stuff of which dangerous "bubbles" are made.



What's wrong with a nice financial inflation? Doesn't it benefit many while apparently hurting very few? Firstly, big financial bubbles inevitably must end sooner or later . . . in a crash. The experiences of 1929, 1937 and 1987 in the U.S. and 1989-90 in Japan are undeniable evidence. A second debilitating effect of a runaway financial mania is that it generates artificial wealth and consumer purchasing power that distorts and imbalances the economy. Lastly, over time, a central bank becomes the prisoner of such a bubble because any monetary tightening would risk pricking it.

WISHING UPON A RECOVERY

Recently, markets grasped at the big upward revisions of employment as proof that the U.S. economic situation is in much better shape than it previously seemed. By contrast, the persistent money and credit crunch and the flood of data signalling a softening economy is being flatly ignored.

There is little or no logic in this new outbreak of euphoria. We have reservations for many reasons. Firstly, the employment numbers relate to the past and say nothing about the future; additionally, they reveal a drastic worsening in the quality of job growth; and lastly, it's a fact that two-thirds of the estimate in job gains is based on computer modelling techniques and not on true counts and surveys.

Our biggest reservation, however, is of a different kind. Of course, stronger employment growth would be very welcome following all the past wailing about a "jobless recovery." There is no dispute on that point. But, to conclude happily that this must brighten the economic outlook is most dubious. It ignores the ugly flip-side: lower productivity growth and higher labour unit costs which both act to squeeze business profits.

Economists, apparently, have yet to learn that they cannot have it both ways. Either the service sector

generates superior productivity gains or it generates stronger gains in employment which tends to be more inflationary. One must come at the expense of the other.

The first unpleasant by-product of this is already evident . . . though ignored by the markets. Revisions for the first quarter of 1993 have already slashed productivity growth from 0.1% to minus 1.6%. For 1992, the year-to-year increase in productivity may well slip from the previously reported 3.1% all the way down to 0.5% or less. The widely trumpeted productivity-led recovery is disappearing into thin air.

The world continues to look to the U.S economy as the lynch pin of a future global recovery. The following question is therefore of central importance: Where is the U.S. economy heading? Early in the year, we were a rather lonely voice warning of a renewed slowdown in the U.S. economy . . . even using the evocative phrase in the February letter, "*that the biggest surprise in 1993 will be the abortion of the U.S. recovery*." It clearly put us out on a limb. But our assessment was born of the strict analysis of the irrefutable fundamentals of persistent and unusually sluggish private credit, broad money and investment.

Now at mid-year, the U.S. economy's sharp slowdown is a fact and no longer the subject of a forecast. For us, the evidence of a weakening economy becomes more compelling with every new statistic.

A STRUCTURAL, NOT A CYCLICAL RECESSION

Globally, markets and economists are obsessed with the cyclical growth differentials between the United States and the rest of the world — particularly Germany. But such temporary swings in these differentials are nothing new. That's always been the typical pattern of the international business cycle.

What's unprecedented, however, is something else: namely the general failure of the countries that went into recession earlier, to stage a normal recovery and to return to "trend growth." The result is a disturbing international synchronization towards longer-term, sub-par growth. The structural, rather than cyclical cause of this sub-par growth pattern is only vaguely understood, if at all.

It used to be conventional wisdom — before thinking was relegated to computer models — that the severity and depth of a recession depends on the magnitude of the imbalances and maladjustments which developed during the preceding boom. Considering the new record-low national savings and investment ratios of the major Anglo-Saxon countries, it is evident that they have suffered the greatest debt excesses and related structural damages.

For the time being, markets interpret sluggish U.S. economic growth as a panacea that promises future growth, low inflation, low interest rates and buoyant financial markets forever. Unfortunately, there is just no precedent for sub-par, non-inflationary growth. Consider these figures: During the last four years from the first quarter of 1989 to the first quarter of 1993, the U.S. economy had compound real GDP growth of 3.8% whereas consumer-price inflation had compound growth of 21%. The proper name for that is "stagflation," not financial nirvana. Just how such an abysmal performance can exhilarate markets for so long is beyond us.

All told, by far the greatest risk for the U.S. economy is the rapidly expanding bond bubble because it gives rise to mind-boggling interest rate risk. This growing vulnerability of the markets and the economy stems from the fact that speculators, above all banks and brokers, have been building up ever larger bond

holdings financed by cheap borrowed money. Of the total bond holdings of banks and brokers, now amounting to approximately $1 trillion, no less than half has been accumulated during the last three years. The danger involved here is that any rise in short-term interest rates diminishing the profit spread, risks triggering a massive selling avalanche forcing bond prices down.

The Fed is widely praised for its supposed ingeniousness in having salvaged the banking system by engineering record-low short-term interest rates. Few seem to realize that these artificially low interest rates, by fuelling the enormous stock and bond bubble, are sowing the seeds for an even bigger liquidity crisis later. A vicious circle is in play.

PROSPECTS FOR EUROPE AND GERMANY

For years, we have been pointing to the large, chronic budget and external deficits of the Anglo-Saxon and other countries as a serious threat to their future growth and stability. Such concerns were generally ignored. The typical counter-argument was that such deficits didn't matter any more in a world of free cross-border capital flows.

Currently, we learn from Anglo-Saxon and other foreign economists that Germany's big budget deficit resulting from the high unification costs has disastrous implications for the economy. Furthermore, we're told that Germany's rather small current-account deficit reflects a drastic loss of competitiveness. We're perplexed. There must be two sets of theories: one for Continental Europe and one for Anglo Saxony.

"*Should the DM be devaluated?* asks a recent research letter from Paribas Capital Markets in London. "*Yes*," was the answer. In line with the apparent consensus opinion in the markets, its author presented a list of fundamentals that should lead to a decline in the D-mark — inflation, budget deficit, current-account deficit, wage levels, and lack of international competitiveness. Let's consider some of these points from a broader perspective.

As one of the toughest critics of budget deficits, we share the worries about the long-term consequences of the German budget deficit. But using this as an indicator of future currency weakness only makes sense if Germany's budget deficit is relatively worse than that of other countries. That's not at all the case. First of all, Germany's large deficit is not of chronic dimensions; it only began two years ago. Other countries — the U.S., Italy and Canada, to name a few — haven't experienced a budget surplus in two decades or more. Secondly, and most importantly, Germany's large budget deficit is more than amply covered by domestic personal savings.

A brief comparison shows this to be so. The total public sector deficit presently accounts for 75% of personal savings in Germany and France, 140% in Britain, and 150% in the United States. Given these much lower savings ratios, the existing budget deficits are definitely far more daunting for the Anglo-Saxon countries.

How bad is German inflation? To quote the previously mentioned bank: "*Germany used to be the bastion of inflationary virtue. No longer. Western Germany has now inflation above the EC average and above the U.S. and Japan. Moreover, this is not temporary. Relative to its key competitors in the core of the ERM, German inflation has been worse for approaching two years and the gap is widening.*"

To judge the German inflation performance just over the last two years and to extrapolate it over the

long-term is either stupid or malicious . . . probably both. In the first place, there are special reasons. While there has been gross mismanagement of German unification by the self-righteous Mr. Kohl, it'll take more than just two or three years to ruin a strong economy. Looking over a longer span of time, Germany's inflation performance looks quite reasonable: Over the 1980s, German annual consumer-price inflation averaged 3%. Comparatively, inflation averaged 5.1% in the U.S., 6.9% in Britain and 7% in France.

The DM bears will object and say that a more recent period would make a more valid comparison. To placate them, let's take the compound consumer price inflation rates for the five years between 1987 and year-end 1992: U.S. 26%, Germany 17%, Britain 33%, and France 17%. To recall, German unification started in 1990. Measuring underlying inflationary pressures and relative changes in international competitiveness, the best gauge is nominal labour unit costs which combines wage growth with productivity growth. We found an illuminating comparison on this in the just published Annual Economic Report of the European Commission.

Basing 1980 at 100, the major countries experienced cumulative rises in their labour unit costs to the end of 1992 as follows: U.S. 165%, Britain 208%, France 176%, Germany 134%, Japan 114%. It should be clear that the main factor that contained the impact of German and Japanese wage rises in the price indexes was strong productivity growth.

Is Germany's current inflation problem indicative of a long-term trend? True, hovering at a rate of 4.2%, German consumer-price inflation appears fairly resilient. But the main reason for that perception is the effect of one-time tax increases and administrative prices. Without their influence, the inflation rate would be nearer 3%, as it will be when these effects drop out. The trend of producer prices tells a very different story. Compared to a year ago, producer prices in Germany are down by 0.3%, in France by 2.3%, up by 2% in the United States and 4% in Britain.

CONCLUSIONS

The D-mark and the Bundesbank are currently under attack. However, the Bundesbank shouldn't be underestimated. Recent events have considerably strengthened the hawks in the Bundesbank. There is an old saying: A central bank is like whipped cream. The longer you whip it, the harder it gets.

The smear campaign by the French and British against the Bundesbank lacks any substance. In the same breath, they accuse it of wasting its credibility by being overly soft and criticise it for ignoring foreign interests by acting too slowly.

Internally, the Bundesbank is in a strong position. Public sentiment is firmly on the side of the bank, too. The German recession is widely seen as a necessary, but painful, adjustment process. Already, West German trade unions have slashed their wage increase demands to little more than 3%. Any blame falls overwhelmingly on the Kohl government and its fiscal mismanagement.

When will the dollar bear market resume? The assault on the D-mark is fuelled by two beliefs: that economic weakness will compel the Bundesbank to slash interest rates sooner rather than later and that the U.S. economy will shortly rebound again. Both assumptions lack any substance.

The evidence we see suggests that the German downturn is slowing and is in the process of bottoming

out. The U.S. economy, on the other hand, is set for a new dip. In short, we can't find any fundamental reasons for a sustainable dollar rally.

We conclude that we're seeing another fake-out move in the dollar. It's based on little more than hype and speculation. And as far as hype goes, sentiment indicators already suggest that the dollar frenzy is near a peak. Actually, for investors wishing to make new commitments to European investments, this would be a good time to do so.

We now see an open interest rate war emerging between France and Germany. French politicians are in a panic about the possibility of a recession starting from an already-high unemployment rate of 11%. France is paying a high price for the ambition of its politicians to dethrone the D-mark as Europe's "anchor currency." We smell some trouble ahead for the franc and its bond market.

There is an enormous financial bubble building up in the U.S. even more bloated than in the infamous 1920s. We can't overemphasize the risks involved. The Fed is caught in the web of its own design having allowed a runaway financial speculation in the interest of propping up the domestic banking system and stimulating the sluggish economy. In due time, a devastating bust will inevitably follow.

Long-term capital conservation and liquidity continue to be the top priorities. We continue to recommend safe harbour in the short-term money securities and bonds of the strong-policy currency countries — Germany, the Netherlands, Switzerland as well as Austria and Belgium.

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Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583

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